



REGULATORY INTERPRETATION 2001-RI-06

Date: May 22, 2001

Subject: Use of residential mortgage loans held by an applicant through a repurchase agreement toward satisfaction of the “10 percent of assets in residential mortgage loans” requirement for Federal Home Loan Bank (Bank) membership

Request Summary:

A Bank sought an interpretation as to whether securities qualifying as “residential mortgage loans” under 12 C.F.R. § 925.1(bb) that are held through repurchase agreements by an insured depository institution applying for membership in the Bank may be counted toward satisfaction of the “10 percent of assets in residential mortgage loans” membership requirement of 12 U.S.C. § 1424(a)(2)(A) and 12 C.F.R. §§ 925.6(b) and 925.10.

Background:

Section 4(a)(2) of the Federal Home Loan Bank Act (Act) states that an insured depository institution may become a member of a Bank only if:

- (A) the insured depository institution (other than a community financial institution) has at least 10 percent of its total assets in residential mortgage loans;
- (B) the insured depository institution’s financial condition is such that advances may be safely made to such institution; and
- (C) the character of its management and its home-financing policy are consistent with sound and economical home financing.

12 U.S.C. § 1424(a)(2)(A). The Federal Housing Finance Board (Finance Board) has reiterated these requirements in section 925.6 of its regulations, 12 C.F.R. § 925.6, and has specifically elaborated upon the “10 percent” requirement of section 4(a)(2)(A) in section 925.10 of its regulations, which states:

An insured depository institution applicant that is subject to the 10 percent requirement of section 4(a)(2)(A) of the Act and section 925.6(b) of this part, shall be deemed to be in compliance with such requirement if, based on the applicant’s most recent regulatory financial report filed with its appropriate financial regulator, the applicant has at least 10 percent of its total assets in residential mortgage loans, except that any assets used to secure mortgage debt securities as described in § 925.1(bb)(6) of this part shall not be used to meet this requirement.

12 C.F.R. § 925.10. The Finance Board has defined the term “residential mortgage loans” (RMLs) to include: (1) home mortgage loans (as defined in 12 C.F.R. §925.1(n)); (2) funded residential construction loans; (3) loans secured by manufactured housing; (4) loans secured by junior liens on one-to-four family property or multifamily property; (5) certain mortgage pass-through securities; (6) certain mortgage debt securities; (7) home mortgage loans secured by a leasehold interest; and (8) loans that finance properties or activities that, if made by a member, would satisfy the requirements for the Community Investment Program or a community investment cash advance program. *See* 12 C.F.R. § 925.1(bb).

An applicant for membership in a particular Bank holds a significant portfolio of mortgage-related securities, including mortgage pass-through securities, collateralized mortgage obligations (CMOs) and other mortgage debt securities, as a buyer pursuant to various repurchase agreements (repos). According to the Bank, many of these mortgage-related securities qualify as RMLs under section 925.1(bb) of the regulations. The Bank seeks an interpretation from the Finance Board as to whether these securities held by the applicant under repo agreements may be counted toward satisfaction of the “10 percent” requirement of sections 925.6(b) and 925.10 of the regulations.

Analysis:

In a typical repo transaction, a holder of a security (seller) sells the security to another party (buyer) for cash while simultaneously contracting with the buyer to repurchase the same—or a similar—security at a point in the future.¹ Repos may be structured in many different ways and are typically short-term (often overnight), but may also be for a longer term. 46 *Syr. L. Rev.* at 1005. The buyer typically is compensated for the use of its money either by setting a repurchase price at a premium above the original purchase price or by charging a stated or floating rate of interest. *Id.* at 1005-06.

Repo agreements usually refer to the subject transactions as purchases and sales of securities. For example, the Master Repurchase Agreement (MRA) developed by the Bond Market Association² states that “the parties intend that all Transactions hereunder be sales and purchases and not loans.” MRA at ¶ 6. However, there is far from universal agreement—either among the courts, regulatory agencies, the accounting profession, or academics - that repos in all cases should be characterized as purchase and sale transactions, rather than as secured loans.³

¹ Jeanne L. Schroeder, *Repo Madness: The Characterization of Repurchase Agreements Under the Bankruptcy Code and the U.C.C.*, 46 *Syr. L. Rev.* 999, 1004 (1996); *see also* Barron’s Finance and Investment Handbook (2nd ed. 1987) at 426-27 (describing a repo as an “agreement between a seller and a buyer, usually of U.S. Government securities, whereby the seller agrees to repurchase the securities at an agreed upon price and, usually, at a stated time”). The same transaction viewed from the point of view of the buyer (*i.e.*, the purchase of a security with a simultaneous agreement to sell it back at some time in the future) is usually known as a reverse repo. 46 *Syr. L. Rev.* at 1004-05. For purposes of this Regulatory Interpretation, the entire transaction will be referred to as a repo regardless of which participant’s role is being discussed.

² In its submission, the Bank asserts that the MRA is “utilized by market participants in virtually all repurchase transactions.”

³ This fact is reflected in the MRA, which further states that “in the event any such Transactions are deemed to be loans, Seller shall be deemed to have pledged to Buyer as security for the performance by Seller of its obligations under each such Transaction, and shall be deemed to have granted to Buyer a security interest in, [sic] all of the

In support of the assertion that repo transactions carried out thereunder are purchases and sales, the MRA provides that “[a]ll of Seller’s interest in the Purchased Securities shall pass to Buyer on the Purchase Date and, unless otherwise agreed by Buyer and Seller, nothing in this agreement shall preclude Buyer from engaging in repurchase transactions with the Purchased Securities or otherwise selling, transferring, pledging or hypothecating the Purchased Securities” MRA at ¶ 8. However, certain provisions of the MRA also imbue the repo transactions thereunder with features that are normally associated with secured loans. For example, under the MRA, the seller is required to transfer additional securities to the buyer if the market value of the existing securities falls below a predetermined amount. MRA at ¶ 4(b). The MRA also provides that the seller is the owner of all interest and other distributions made on the underlying security pending repurchase. MRA at ¶¶ 3(c) and 5.

Cases addressing the characterization of repos have generally fallen within three broad categories: tax cases, securities fraud cases and bankruptcy cases. *See Cohen v. Army Moral Support Fund*, 67 B.R. 557, 594-96 (Bankr. N.J. 1986) (surveying the range of cases on the issue). It appears that, in most of these cases, the courts found the repo transaction in question to have characteristics of both a purchase and sale and a secured loan, but based their ultimate conclusion as to the nature of the transaction on the particular statutory and regulatory provisions and rights and privileges that were relevant to each case. For example, in several of the tax cases, the courts were concerned about the tax avoidance possibilities associated with the seller characterizing the transactions at issue as purchases and sales and, therefore, focused upon the economic substance of the transactions to the exclusion of the expressed intent of the parties. *See, e.g., Union Planters Nat’l Bank of Memphis v. United States*, 426 F.2d 115 (6th Cir. 1970); *American Nat’l Bank of Austin v. United States*, 421 F.2d 442 (5th Cir. 1970); *First American Nat’l Bank of Nashville v. United States*, 467 F.2d 1098 (6th Cir. 1972).

Conversely, in securities fraud cases, the trend has been to treat repo transactions as purchases and sales of securities for purposes of applying the anti-fraud provisions of the Securities Exchange Act of 1934 (Exchange Act). *See, e.g., SEC v. Gomez*, 1985 Fed. Sec. L. Rep. § 92,013 (S.D. Fla. 1985); *City of Harrisburg v. Bradford Trust Co.*, 621 F. Supp. 462 (M.D. Pa. 1985); *SEC v. Miller*, 495 F. Supp. 465 (S.D.N.Y. 1980) (although the court noted in dictum that “[f]rom a purely economic perspective, a repo is essentially a short-term collateralized loan”). These decisions are based largely on the premise that under section 10(b) of the Exchange Act, the terms “purchase” and “sale” are to be construed broadly where such construction would advance the purposes of the statute.

In the bankruptcy cases, courts typically have held that repos are purchase and sale transactions.⁴ *See, e.g., Cohen*, 67 B.R. at 557; *Resolution Trust Corp. v. Aetna Casualty and Sur. Co.*, 25 F.3d 570, 571-73 (7th Cir. 1994); *Jonas v. Farmer Bros. Co.*, 145 B.R. 47, 53 (Bankr. 9th Cir. 1992).

Purchased Securities with respect to all Transactions hereunder and all Income thereon and other proceeds thereof.” MRA at ¶ 6.

⁴ The one notable exception is *In re Lombard-Wall*, 23 B.R. 165, 166 (Bankr. S.D.N.Y. 1982), where the court found that a repo buyer’s interest in the underlying securities was a mere security interest and, therefore, held that the automatic stay provisions of the Bankruptcy Code barred the repo buyer from liquidating the securities in the event that the seller filed for bankruptcy prior to the agreed-upon repurchase date. This decision prompted Congress to amend the Bankruptcy Code to permit purchasers of securities in repo transactions to liquidate the securities immediately upon a seller’s bankruptcy, although the Code does not expressly characterize a repo transaction as a purchase and sale. *See* 11 U.S.C. § 559.

In *Cohen*, which generally is considered the leading case in support of the proposition that repos are purchase and sale transactions, *see* 46 Syr. L. Rev. at 1011, and which surveys the issue comprehensively, the court considered the similarities between repos and secured loans and ultimately upheld the purchase and sale characterization that was expressly set out in the repo agreement at issue. The *Cohen* court summarized its findings by stating:

[R]epos and reverse repos are hybrid transactions which do not fit neatly into either a secured loan or purchase and sale classification. There is no question that repo and reverse repo transactions have functional attributes which resemble collateralized loans. The initial taking of margin (the “haircut”), the right of substitution, and the “mark-to-market” provisions are undeniably secured loan characteristics not commonly found in purchase and sale transactions. In addition, principal and/or interest paid on the underlying securities remains the property of the seller. On the other hand, the repo buyer’s unrestricted right to trade the securities during the term of the agreement represents an incident of ownership which does not pass to a lender in a collateralized loan transaction.

Cohen, 67 B.R. at 596-97. Ultimately, the court upheld the characterization of the repo transactions at issue as purchases and sales, stating, “In any event, the proper characterization of repo and reverse repo agreements does not rest solely on an evaluation of the economic substance of the individual transactions. Rather, the intent of the parties viewed in the context of the entire market in which these transactions takes place is the controlling consideration” *Id.* at 597.

In determining whether an applicant for Bank membership can be said to “ha[ve] ... assets in residential mortgage loans” held by the applicant pursuant to a repo agreement for purposes of section 4(a)(2)(A) of the Act and sections 925.6(b) and 925.10 of the regulations, the key question is whether the logic supporting a purchase and sale characterization is relevant to the purposes underlying the 10 percent requirement in the Act and the regulations. While, as demonstrated above, the characterization of a repo transaction is dependent upon its context, there is ample legal precedent to support the assertion that a repo transaction is a purchase and sale. As mentioned above, the attributes of a typical repo transaction (including those under the MRA) that suggest a purchase and sale characterization are that: (1) the parties have stated in the repo agreement that the transaction is a purchase and sale; and (2) the buyer is able to dispose of the underlying securities and substitute similar securities to be repurchased by the seller.

Courts have looked beyond the expressed intent of the parties primarily in cases where failing to do so could serve to thwart an important statutory scheme or to affect adversely the rights of third parties. With respect to the 10 percent requirement, there are no third party rights at issue. As such, the key question is whether considering repos to be purchase and sale transactions pursuant to which an applicant “has assets in residential mortgage loans” may somehow serve to subvert the membership requirements of the Act and the regulations. The Finance Board believes that it does not.

First, the 10 percent requirement is a “point-in-time” test - that is, an applicant need only show that, as of the date of its most recent regulatory report filed with its appropriate regulator (“call report”), it has at least 10 percent of its assets in RMLs. Even if, on the date of the most recent call report, an institution held indisputable “long” positions in a portfolio of RMLs comprising more than 10 percent of its total assets, there is nothing in the Act or the regulations that requires

the institution to continue to hold that level - or any - RMLs thereafter.⁵ There are other provisions of the Act and regulations that address a member's commitment to housing finance both before (makes long-term mortgage loans, *see* 12 U.S.C. § 1424(a)(1)(C); 12 C.F.R. § 925.6(a)(3); housing policy consistent with sound and economical home financing, *see* 12 U.S.C. § 1424(a)(2)(C); 12 C.F.R. § 925.6(a)(6)) and after (advances may be secured only by certain mission-related assets, *see* 12 U.S.C. § 1430(a)(3); 12 C.F.R. § 950.7(a)) gaining membership in the Bank. As such, even if an applicant's most recent call report reflects a RML that the applicant has contracted to sell, or has sold, on a date after the date of the call report, such a RML may still be counted toward satisfaction of the 10 percent requirement.

Second, although the official legislative history of the Act's membership provision provides no insight into the precise intent behind the 10 percent requirement,⁶ there is indication that the membership requirements are to be construed broadly. The Conference Report on the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), Pub. L. 101-73, 103 Stat. 412 (1989), which added the membership requirements for insured depository institutions to section 4 of the Act, states generally that the amendments were intended "to provide for expanded membership in the Banks to include Federally insured commercial banks and credit unions that engage in mortgage lending." H.R. Rep. 222, 101st Cong., 1st Sess. (1989). The Conference Report further states, "This expansion of Bank membership is intended to promote and sustain housing finance and the Banks. The Committee believes that the extension of membership to insured commercial banks and credit unions that engage in mortgage lending will strengthen the Banks and their ability to support the mortgage market." *Id.*

Because part of the reason behind the 1989 amendments to section 4 was to strengthen the Banks by expanding their membership base, it appears that the Finance Board's construction of the 10 percent requirement need not be overly restrictive. In 1999, Congress further amended section 4 to make it even easier for certain institutions (community financial institutions) to gain Bank membership by exempting these entities from the 10 percent requirement. *See* 12 U.S.C. § 1424(a)(4). Although the institution in question here is not a community financial institution, the 1999 amendments nonetheless are further evidence that the membership provisions of the Act are not to be applied restrictively.

Finally, although holding RMLs through repo agreements does not demonstrate the level of commitment to housing finance that holding RMLs for the long term does, RML-related repo transactions nonetheless serve to provide greater liquidity to the RML markets. In this sense, holding a RML through a repo serves to promote housing finance, even if only to a minimal extent.

Conclusion:

Considering the above, an insured depository institution applying for Bank membership whose most recent quarterly call report reflects that the applicant holds RMLs (as defined in 12 C.F.R.

⁵ Of course, if a member holds little or no RMLs when it is a member, it will likely have very few assets that are eligible to secure advances. Banks should make clear to applicants that satisfy the 10 percent requirement only by a narrow margin that they may be disadvantaged when attempting to draw down advances.

⁶ However, the Conference Report does state that "[m]eeting the specific asset threshold test [(i.e., the 10 percent requirement)] does not raise any presumption with respect to whether the applicant's policies are consistent with sound economic home financing." H.R. Rep. 222, 101st Cong., 1st Sess. (1989).

§ 925.1(bb)) as a buyer in a repo transaction may count these RMLs as “assets held” toward satisfaction of the 10 percent requirement of section 4(a)(2)(A) of the Act and sections 925.6(b) and 925.10 of the regulations, so long as the repo agreement governing the transactions: (1) states that the repo is a purchase and sale transaction; and (2) permits the buyer to dispose of the underlying securities through resale or other means, before the repurchase date (*i.e.*, the buyer need only provide similar securities for repurchase by the seller).

A Regulatory Interpretation applies only to the particular transaction or activity proposed by the requestor, may be relied upon only by the requestor, and is subject to modification or rescission by action of the Board of Directors of the Finance Board. 12 C.F.R. part 907.